

# **CALIFORNIA LOTTERY**

Audit Report

## **RETAILER NETWORK**

*January 1, 2009, through April 30, 2011*



**JOHN CHIANG**  
California State Controller

January 2013



**JOHN CHIANG**  
**California State Controller**

January 14, 2013

California Lottery Commission  
600 North Tenth Street  
Sacramento, CA 95811

Dear Commissioners:

The State Controller's Office audited the California Lottery's (Lottery) administrative and internal control over Lottery's retailer network application process and maintenance for the period of January 1, 2009, through April 30, 2011. Our audit of the retailer network disclosed the following deficiencies:

- The Lottery was deficient in requesting the retailers' personal credit report, placing retailers on probation, and requiring deposit from retailers when non-sufficient fund returns occurred.
- The Lottery did not process applicant and retailer appeals within the 60 calendar days required by Lottery regulations.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

*Original signed by*

**JEFFREY V. BROWNFIELD**  
Chief, Division of Audits

JVB/vb

cc: Phil Tagami, Chairperson  
California Lottery Commission  
John Smolin, Vice-Chairperson  
California Lottery Commission  
Gregory Ahern, Commissioner  
California Lottery Commission  
Nathaniel Kirtman III, Commissioner  
California Lottery Commission  
Connie M. Perez, Commissioner  
California Lottery Commission  
Robert T. O'Neill, Director  
California Lottery  
Nicholas Buchen, Deputy Director, Finance Division  
California Lottery  
Roberto Zavala, Chief Internal Auditor  
California Lottery

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# Audit Report

## Summary

The State Controller's Office (SCO) audited the California Lottery's (Lottery) retailer network for the period of January 1, 2009, through April 30, 2011.

Our audit disclosed the following deficiencies in the Lottery's administrative and internal controls over Lottery's retailer network application process and maintenance during the period of January 1, 2009, through April 30, 2011:

- The Lottery was deficient in requesting retailers' personal credit reports, placing retailers on probation, and requiring deposits from retailers when non-sufficient fund returns occurred.
- The Lottery did not process applicant and retailer appeals within the 60 calendar days required by Lottery regulations.

## Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "...the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.46.6, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

## Objectives, Scope, and Methodology

The Lottery Act authorizes the Lottery commission to contract with Lottery game retailers for the purpose of selling online and Scratchier tickets to the public. There are over 21,000 Lottery retailers throughout the State of California. The retailers form a Scratchier and online retailer network that produces ticket-sales revenue for the Lottery. The network is constantly changing as a result of the recruitment of new retailers, changes of ownership, voluntary and involuntary terminations, and new contracting activities.

At any given time, hundreds of retailer terminals are in the process of being activated or deactivated. Activated status enables the retailer to sell Lottery products, and deactivated status prevents the retailer from selling Lottery products.

We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The purpose of the audit was to determine if the Lottery is maintaining effective systems of administrative and internal accounting controls over the retailer network application process and maintenance during the period of January 1, 2009, through April 30, 2011.

The detailed objectives of the audit were to determine whether the Lottery:

- Has adequate internal controls for the retailer application and selection process and for maintaining the retailer network, thus safeguarding against any loss of revenue to the State; and
- Is abiding by laws, rules, and regulations in maintaining its retailer network.

The procedures performed during the audit included:

- Reviewing the California Lottery Act, the State Administrative Manual, and any other applicable rules and regulations related to the retailer network;
- Reviewing work performed by the Lottery Internal Audits Office and any other Lottery section, the SCO and any other external audit organizations;
- Analyzing and evaluating the retailer application process;
- Analyzing and evaluating changes to the Scratcher and online retailer network (i.e. new terminal placements, relocations, terminations);
- Obtaining an understanding of the components of internal control sufficient to conduct the audit; and
- Performing tests of procedural compliance for processes related to the management of the retailer network.

**Conclusion**

Our audit of the Lottery's retailer network disclosed that the Lottery was deficient in requesting the retailers' personal credit report, placing retailers on probation, and requiring deposit from retailers when non-sufficient funds returns occurred. In addition, our audit found that the Lottery did not process applicant and retailer appeals within the 60 calendar days required by Lottery Regulations. The findings and recommendations section of this report summarize the control deficiencies noted.

**Views of  
Responsible  
Official**

The SCO issued a draft to the Lottery dated November 7, 2012. Robert T. O'Neill, Director, responded by the attached letter dated December 30, 2012. Mr. O'Neill agreed with recommendations for Finding 1 and Finding 2.

**Restricted Use**

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

*Original signed by*

JEFFREY V. BROWNFIELD  
Chief, Division of Audits

January 14, 2013

# Findings and Recommendations

**FINDING 1—  
The Lottery was  
deficient in requesting  
retailers' personal  
credit reports, placing  
retailers on probation,  
and requiring deposits  
from retailers when  
non-sufficient fund  
returns occurred.**

The first occurrence of a payment returned by a bank for non-sufficient funds (NSF) could be an indication to the Lottery that a retailer might have a financial problem. By requesting a credit report on the retailer, the Lottery receives an overview of the retailer's financial history so that the Lottery can take proactive action against loss of revenue by terminating the retailer or placing the retailer on probation with or without deposit if a financial problem is disclosed.

Early detection of a retailer's financial problems can reduce the Lottery's revenue losses.

Whenever a retailer is terminated, the Lottery risks being unable to collect an average of two weeks' revenue. A review of retailer terminations shows that one of the first indicators of financial risk for the Lottery is an NSF return.

From the Lottery's 4,868 NSF returns during the period from January 1, 2009, through April 30, 2011, we selected a sample of 24 retailers who had NSF returns and reviewed a total of 69 NSF returns from those retailers. Twelve (50%) of the retailers had NSF returns for which a credit report should have been requested for financial credit review. Credit reports were not needed for the rest of the retailers because they were terminated due to a lack of payment or because the NSF return was related to a bank error.

- Our audit disclosed that the Lottery was deficient in requesting a retailer's personal credit report for financial review for 3 of 12 (25%) retailers that had NSF returns and for which the Lottery should have requested credit reports. The results are as follows:
  - 1 of 12 retailers had four NSF returns on August 4, 2010; September 16, 2010; March 17, 2011; and April 7, 2011. A credit report was not requested for review until the fourth NSF return, contrary to the Lottery's requirement that a credit report should be requested after one or two NSF returns.
  - For 2 of 12 retailers, no credit report was requested when the second NSF return occurred.
- Our audit further disclosed that 3 of 12 retailers that had NSF returns were not placed on probation properly as follows:
  - 2 of 12 retailers were not placed on probation when the third NSF return occurred.
  - 1 of 12 retailers was not placed on probation when the second NSF return occurred.

In some cases, a credit report was not requested to determine if the retailer should be placed on financial probation. In some cases, even though a credit report was pulled and disclosed past due amounts and repeated delinquencies, the retailer may not have been placed on financial probation. Only if the credit report disclosed significant



financial difficulties—such as a large number of past due bills, bankruptcy, or foreclosure—were the retailers placed on probation. The Lottery’s current practice does not place retailers with financial credit issues on close monitoring via the tool of financial probation.

- Our audit disclosed that deposits were not sufficiently utilized to reduce the Lottery’s loss of revenue. There are no written guidelines or procedures to determine if a retailer should be required to make a deposit upon placement on financial probation. The Lottery’s practice of requiring a deposit is not uniformly or consistently applied. According to a Lottery staff member, if a retailer’s credit report shows a large number of past due bills or collections, the Lottery would require a minimum deposit of \$2,500.

Retailers that had NSF returns generally were not required by the Lottery to make a deposit to guarantee payment. For example, a retailer who was approved to sell Lottery tickets in 2008 was placed on financial probation due to the financial history disclosed on a credit report. After the probation ended, the retailer incurred 11 NSF returns (see Table 1). The credit report was requested after the first NSF return and disclosed that the retailer had 23 delinquencies of 30 days and 2 delinquencies of 60 days in the past seven years, as well as a current past due account of \$86. However, the retailer was not placed on probation because the credit history on the report did not disclose an inability to pay according to Lottery staff. The Lottery did not place the retailer on probation until the fourth NSF return. Financial probation should have been instituted after the second NSF return according to Lottery policy. Further, a deposit was not required of the retailer despite multiple NSF returns and a negative credit history. The Lottery was able to recover \$65 in funds owed the Lottery via a state income tax offset. The retailer ended up owing the Lottery a total of \$23,443, which was unpaid as of August 15, 2011. If a deposit had been required, the Lottery would have mitigated some of its loss of revenue by offsetting the deposit with the outstanding liability.

**Table 1**

NSF Number	NSF Return Date	Default Amount	History
1	05/14/2009	\$ 6,691	Credit report was requested and disclosed \$86 past due and repeated delinquencies.
2	08/05/2009	9,976	Lottery called to request payment on NSFs or terminals would be shut off. NSFs were paid on 08/05/2009.
3	10/01/2009	7,627	Lottery called to request payment. Paid on 10/01/2009.
4	10/28/2009	12,985	Made a payment on 10/29/2009. Put on probation without deposit for excessive NSFs with probation term 11/19/2009 to 05/19/2010.
5	11/04/2009	8,319	Retailer was deactivated. Lottery informed retailer not to incur any more NSFs. Retailer made payment on 11/04/2009. Retailer was re-activated
6	02/10/2010	10,685	Retailer was deactivated. Retailer made payment on 02/17/2010. Retailer was re-activated.
7	02/24/2010	3,237	Retailer paid on 02/24/2010.
8	04/15/2010	5,359	Retailer was evicted by landlord. Lottery retrieved equipment. Retailer stopped making payments on prior Lottery sales.
9	04/21/2010	4,369	NSF incurred after termination.
10	04/22/2010	4,363	NSF incurred after termination.
11	05/06/2010	9,690	NSF incurred after termination.

The Lottery's NSF returns procedures state, in part, "When the first or second NSF occurs, request owner's personal credit report . . . or review current credit report on file in unit if less than six (6) months old."

The Lottery's NSF returns procedures further state, "After the NSF is paid and there are 2 or more NSF returns within a six (6) month period, the retailer is placed on probation."

#### Recommendation

The Lottery should:

- Require that credit report be run as required by Lottery procedures when a NSF return is incurred by a non-terminated retailer.
- Develop written procedures for deposit requirements when NSF returns occur.
- Strengthen the Lottery's procedures in requesting retailers' personal credit reports, placing retailers on probation, and requiring deposits from retailers when NSF returns occur. Probation should be used more frequently, and the deposit amount should be increased.

#### Lottery's Response

The Lottery agrees with the recommendation. Lottery procedures have been strengthened to require obtaining retailers' personal credit reports when two valid NSF returns occur and to require detailed documentation when extenuating circumstances exist. Staff is also reviewing procedures for deposit requirements and placing retailers with financial credit issues on probation to ensure they reflect best practices and are consistent with Lottery policies.

In addition, the Lottery is developing a retailer management unit that will address risk management issues in its retailer network. This will ensure that appropriate risk mitigation efforts are employed in its network of retailers throughout the life of the contract.

#### SCO's Comment

The Lottery agrees with the recommendation.

**FINDING 2—  
The Lottery did not  
process applicant and  
retailer appeals within  
the 60 calendar days  
required by Lottery  
regulations.**

We tested 4 out of 137 (3%) of appeals related to security issues from January 1, 2009, through April 30, 2011. Our audit disclosed that the Lottery did not process three out of four appeals within the 60 calendar days required by Lottery regulations. For example, an existing retailer was terminated on December 29, 2010, due to a criminal history disclosed by the Department of Justice. The retailer filed an appeal on January 6, 2011. The Lottery did not issue its final decision until May 17, 2011, which is 70 days past due; a violation of the Lottery regulations. As a result, the Lottery may have lost revenue from terminated retailers whose appeals were not processed within 60 calendar days as required by regulations.

Section III.C.7, of the Lottery regulations, Applicant and Retailer Appeal Process, states:

The applicant or retailer shall be notified, in writing, of the Director's final decision to grant or deny the appeal, the reason(s) therefore, and the effect of the decision on the disapproved application or the termination of the retailer's contract(s) within 60 calendar days, and up to an additional 15 calendar days, from the Director's receipt of the appeal, documentation, and/or the additional documentation or information requested by the Director, whichever occurs later.

Recommendation

The Lottery should develop a proper oversight to ensure that the appeals are resolved within 60 calendar days from the date of receipt.

Lottery's Response

The lottery agrees with the recommendation and will develop a proper oversight to ensure that the appeals are resolved within 60 calendar days from the date of the receipt. The lottery recognizes the importance of providing an appeal process that is both fair and timely.

. . .For the retailer in question, no revenues were lost as a result of this appeal taking longer than 60 days to complete.

SCO's Comment

The Lottery agrees with the recommendation.

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**Attachment—  
California Lottery's  
Response to Draft Report**

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November 30, 2012

Mr. Jeffrey V. Brownfield, Chief  
Division of Audits  
State Controller's Office  
P.O. Box 942850  
Sacramento, CA 94250-5874

Re: Lottery Retailer Network Audit

Dear Mr. Brownfield:

The California Lottery (Lottery) offers the following comments regarding the recently concluded audit of the Lottery's Retailer Network audit conducted by the State Controller's Office (SCO). As stated in the audit report dated November 07, 2012, the specific objectives of the audit (for the period January 01, 2009 through April 30, 2011) were to determine if the Lottery:

1. Has adequate internal controls for the retailer application and selection process and for maintaining the retailer network, thus safeguarding against any loss of revenue to the State; and
2. Is abiding by laws, rules, and regulations in maintaining its retailer network.

We are pleased with the results of the audit and thank you for the opportunity to respond to the draft report. Although no significant internal control issues were identified, the audit identified opportunities to improve current practices and procedures in requesting retailers' personal credit reports, placing retailers on probation, requiring deposits from retailers when NSF returns occur, and to ensure the timely completion of retailer appeals as required by Lottery regulations. The Lottery's Finance and Security/Law Enforcement (SLED) Divisions have implemented changes to address these issues. Please see the following responses to your findings and recommendations.

#### **Finding 1**

The Lottery was deficient in requesting retailers' personal credit reports, placing retailers on probation, and requiring deposits from retailers when non-sufficient fund returns occurred.

#### **Recommendation**

The Lottery should:

- Require that credit report be run as required by Lottery procedures when a NSF return is incurred by a non-terminated retailer.
- Develop written procedures for deposit requirements when NSF returns occur.
- Strengthen the Lottery's procedures in requesting retailers' personal credit reports, placing retailers on probation, and requiring deposits from retailers when NSF returns occur. Probation should be used more frequently, and the deposit amount should be increased.

**Response**

The Lottery agrees with the recommendation. Lottery procedures have been strengthened to require obtaining retailers' personal credit reports when two valid NSF returns occur and to require detailed documentation when extenuating circumstances exist. Staff is also reviewing procedures for deposit requirements and placing retailers with financial credit issues on probation to ensure they reflect best practices and are consistent with Lottery policies.

In addition, the Lottery is developing a retailer management unit that will address risk management issues in its retailer network. This will ensure that appropriate risk mitigation efforts are employed in its network of retailers throughout the life of the contract.

**Finding 2**

The Lottery did not process applicant and retailer appeals within the 60 calendar days required by Lottery Regulations.

**Recommendation**

The Lottery should develop a proper oversight to ensure that the appeals are resolved within 60 calendar days from the date of receipt.

**Response**

The Lottery agrees with the recommendation and will develop a proper oversight to ensure that the appeals are resolved within 60 calendar days from the date of receipt. The Lottery recognizes the importance of providing an appeal process that is both fair and timely.

As a clarifying comment, the draft report cites an appeal where an existing retailer was terminated on December 29, 2010 due to a criminal history disclosed by the Department of Justice. The appeal was denied and their contract was terminated on May 31, 2011. Depending on the nature of a retailer violation, the retailer may be allowed to continue selling tickets while their appeal is processed. The retailer in question was allowed to continue selling Lottery products. However, the draft audit report notes that, "...the Lottery may have lost revenue from terminated retailers whose appeals were not processed within 60 calendar days as required by regulations." For the retailer in question, no revenues were lost as a result of this appeal taking longer than 60 days to complete.

If you have any additional questions, please contact the Audit Chief, Roberto Zavala at (916) 822-8358.

Sincerely,

  
Robert T. O'Neill  
Director

**State Controller's Office  
Division of Audits  
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**<http://www.sco.ca.gov>**